United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

ORIGINAL

76-5020

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P/S

United States Court of Appeals

For the Second Circuit

Docket No. 76-5020

IN THE MATTER

OF

F. O. BAROFF COMPANY, INC.,

Debtor.

AMERICAN BANK & TRUST COMPANY,

Plaintiff-Appellant,

against

EDWARD S. DAVIS, Trustee,

Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

REPLY BRIEF OF PLAINTIFF-APPELLANT

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AMERICAN BANK & TRUST COMPANY,	:	
Plaintiff-Appellant,	:	
-against-	:	
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Defendant-Appellee.	:	

REPLY BRIEF OF PLAINTIFF-APPELLANT AMERICAN BANK & TRUST COMPANY

Preliminary Statement

Plaintiff-appellant American Bank & Trust Company ("American") submits this brief in reply to the brief submitted by defendant-appellee Edward S. Davis, Trustee (the "Trustee") for the liquidation of the

business of F. O. Baroff Company, Inc. ("Baroff"), pursuant to the Securities Investor Protection Act of 1970. American's prior brief argued, inter alia, that the Trustee's motion for summary judgment was erroneously granted since the insurance proceeds received from the Insurance Company of North America ("INA") did not constitute an asset of Baroff's general estate, but a trust fund for the benefit of American, the unsatisfied creditor whose claim gave rise to the insurance payment.

POINT

AMERICAN'S INTEREST IN THE INSURANCE PROCEEDS WAS SUPERIOR TO THAT OF THE TRUSTEE'S.

As demonstrated in American's main brief (pp. 14-18), by virtue of Section 167 of New York's Insurance Law (McKinney 1966) title to the INA bond vested in American as the injured claimant and not in the Trustee. Further, only American was entitled to maintain an action on the bond and its proceeds constituted a trust fund for American's benefit rather than an asset of Baroff's general estate. Merchants Mutual Automobile Liability Insurance Co. v. Smart, 267 U.S. 126, 137, 69 L.Ed. 538 (1925); Cissell v. Amer. Home Assurance Co., 521 F.2d 790 (6th Cir. 1975) cert. denied ____ U.S. ____, 96 S. Ct. 857 (1976); Fix v. Automobile Club Inter-Insurance Exchange, 413 S.W.2d 194 (Mo. Sup. Ct. 1967); Fidelity Union Casualty Co. v. Hanson, 26 S.W.2d 395 (Tex. Ct. of Civil Appeals, 1930), aff'd 44 S.W.2d 985 (Tex. Comm. of Appeals, 1932) cert. denied 287 U.S. 599, 77 L.Ed. 522. See also, 3 Remington On Bankruptcy, §1251 (1957); In Re Fay Stocking Co., 95 F.2d 961 (6th Cir. 1938).

Although the Trustee concedes that Section 167 applies to indemnity policies,* such as the INA bond, he attempts to distinguish certain of the foregoing authorities by arguing that they construed liability policies as distinguished from indemnity policies (Trustee's Brief, p. 9). This approach overlooks the fact that Section 167 converts an indemnity policy into a liability policy upon the insured's insolvency or bankruptcy (see Coleman v. New Amsterdam Cas. Co., 247 N.Y. 271, 275 (1928); Appellant's Brief, pp. 13-14). It further ignores that under Section 167 every insurance policy is deemed to contain a provision that the insured's bankruptcy or insolvency shall not release the insurer and that the injured party can directly bring suit under the policy to recover his damages.

As stated by Chief Judge Cardozo in Coleman v. New Amsterdam Casualty Co., supra at 275:

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* Indeed, both the District Court and the Bankruptcy Court held that Section 167 applied to indemnity policies (247a, 236a). (Unless otherwise indicated, parenthetical references are to the Joint Appendix).

> The effect of the statute is to give to the injured claimant a cause of action against the insurer for the same relief that would be due to a solvent principal seeking indemnity and reimbursement after the judgment had been satisfied.

Thus, the cases which construed statutes similar to Section 167 or policies containing similar provisions are directly applicable to the issues presented herein. See, Cissell v. American Home Assurance Co., supra (policy contained statutory language); In Re Fay Stocking Co., supra (provisions of both policy and statute were similar to Section 167); Fix v. Automobile Club Inter-Insurance Exchange, supra (statute similar to Section 167).

The Trustee further asserts that title to the INA bond and any rights of action thereunder vested in him upon his appointment, citing Hanover Ins. Co. v. Tyco Industries Inc., 500 F.2d 654 (3d Cir. 1974) and In Re Podolsky, 115 F.2d 965 (3d Cir. 1940). (Trustee's Brief pp. 8-9) However, the rule is otherwise where

by statute, contract, or the policy's terms, the injured claimant has a beneficial interest in the policy although he is not explicity named therein. See, e.g., Cissell v. American Home Assurance Co., 521 F.2d 790, 792 (6th Cir. 1975) cert. denied ____ U.S. ____ 96 S. Ct. 857 (1976); Century Ins. Co. v. First Nat. Bank, 102 F.2d 726 (5th Cir. 1939); Fix v. Automobile Club Inter-Insurance Exchange, 413 S.W.2d 194, 196-97 (Mo. Sup. Ct., 1976); Morrison v. Warren, 174 Misc. 233, 20 N.Y.S.2d 26 (Sup. Ct.) aff'd 260 App. Div. 998, 24 N.Y.S.2d 988 (1st Dept. 1940); 3 Remington On Bankruptcy, §1248 p. 115 (1957). See also, In Re Fay Stocking Co., Inc., 95 F.2d 961 (6th Cir. 1938); B. N. Exton & Co., Inc. v. Home Fire Ins. Co., 249 N.Y. 258 (1928).

Under those circumstances, the claimant's beneficial interest is superior to that of the bankruptcy trustee even though the policy was obtained and paid for by the bankrupt. Cissell v. American Home Assurance Co., supra at 792; Fix v. Automobile Club Inter-Insurance Exchange, supra at 196-97. See also, In Re Fay Stocking Co., supra.

Indeed, Hanover Ins. Co. v. Tyco Industries Co., supra, and In Re Podolsky, supra, do not hold to the contrary for in those cases the injured claimants did not

have any beneficial interest in the policies. In Hanover Ins. Co., supra, the Court held that a creditor could not recover insurance proceeds received for certain property it had sold to the bankrupt since the policy only protected against loss of the bankrupt's property, the creditor was not a party to the policy, nor an intended beneficiary thereof, and the bankrupt had not undertaken to obtain insurance for the creditor's benefit. (500 F.2d at 656). These facts must be contrasted to those presented herein where, by virtue of Section 167 and the applicable authorities, American has a specific interest in the policy.

Similarly, in Podolsky, supra, the Court rejected an attempt to recover the proceeds under a bankrupt bailee's fire insurance policy because the policy did not cover the creditors' claims. The policy protected against loss on the bankrupt's "interest in and his legal liability for" property of others. The creditor-bailors failed to establish that the bankrupt had any legal liability for the loss of their property. (115 F.2d at 967).

Moreover, the Trustee does not dispute that federal public policy and regulations now require broker-dealers to maintain bonds, similar to the one at issue, for the protection of third parties, such as American (see American's Main Brief, pp. 24-27). Thus, under Section 167, and existing public policy, American had a direct interest in the INA bond and its proceeds.

The Trustee, in commenting upon that policy, contends that it was not the debtor which received the benefit of the insurance proceeds but rather the debtor's general creditors (Trustee's Brief p. 13). The Trustee's assertion that the proceeds were paid to Baroff's general creditors is inaccurate for on March 5, 1975, while the respective motions for summary judgment were sub judice, the Trustee obtained an order* authorizing him to

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* The March 5, 1975 order provided, inter alia, as follows:

> ORDERED, that the Trustee is authorized and directed to assign all right, title and interest of the Debtor's estate in the $100,000 in insurance proceeds received from INA to SIPC in partial payment of its priority administrative claim ***.

assign the proceeds to the Securities Investor Protection Corporation ("SIPC") in partial payment for its administrative claim (Document No. 83, Record on Appeal).

Thus, it was SIPC and not Baroff's General creditors which received the proceeds. To allow SIPC to recover the bond's proceeds in view of its professed concern that such bonds were needed to protect claimants not afforded SIPC protection (Appellant's Brief pp. 24-27) is contrary to the expressed policy* underlying the enactment of Securities and Exchange Commission Rule 15b10-11, §17 C.F.R. 240.15b10-11, and Section 32 of the NASD Rules of Fair Practice.

In addition, even if the proceeds were not paid to SIPC, American's interest therein was superior to that of Baroff's general creditors. Section 167 expressly establishes

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* For a discussion of the policy underlying the enactment of SEC Rule 15b10-11 and Section 32 of the NASD Rules of Fair Practice, see Appellant's Brief pp. 24-27. It is particularly significant that the Trustee does not take issue with that discussion.

the right of an injured party to the proceeds while his claim remains unsatisfied. The general creditors, however, had no such rights since their claims were not within the bond's coverage. As stated in In Re Fay Stocking Co., 95 F.2d at 962-63 (6th Cir. 1938):

> *** only such creditors as those whose claims against the assured arise out of personal injury covered by the policy in suit may assert a successful claim to the insurance fund, and the assured or its Trustee, if either of them collects from the insurer, rests under a legal obligation to hold the funds collected in trust for the injured party.

In transacting business with Baroff, the general creditors did not receive or bargain for any interest in the collateral pledged to American. They simply assumed the risk of loss if Baroff was unable to meet its obligations. In direct contrast, American bargained for and received the right to resort to the collateral if Baroff defaulted. As set forth in American's main brief (p. 22), American could have initially recovered the bond's proceeds and then, as a secured creditor, resorted to the collateral to satisfy the unpaid portion of its claim. To refute this argument the Trustee contends that upon Baroff's default the collateral would have been immediately payable to American "thereby giving rise to a loss by the Insured." (Trustee's Brief p. 11

f.n. 9) This contention is erroneous since a secured creditor need not initially resort to its collateral but can enforce its claim in any other lawful manner.* American Bank & Trust Company v. Lichtenstein, 48 A.D.2d 790, 791, 369 N.Y.S.2d 155, 158 (1st Dept. 1975) aff'd ___ N.Y.2d ___ (1976); Conlew, Inc. v. Newman, 240 App. Div. 511, 270 N.Y. Supp. 695 (1st Dept. 1934); First Trust & Deposit Co. v. W.W. Conde Hardware Co., 47 Misc.2d 338, 262 N.Y.S.2d 565 (Sup. Ct. 1965); Unif. Comm. Code § 9-501 (McKinney 1964).

American had recourse to two funds to satisfy its claims against Baroff, namely, its collateral and the bond. By pursuing its claims against one of those funds American did not impair or waive its rights in the other fund since its claim had not been satisfied. See Matter of Adrian Research

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* Indeed, American's Security Agreement (p. 25a) specifically gave it such an option for it provided:

> 6. The Bank in its discretion may, whether or not any of the liabilities be due *** sue for, collect or receive any money or property at any time payable or receivable on account of or in exchange for, or make any compromise or settlement deemed desirable with respect to any of the Security, but shall be under no obligation to do so***.

& Chemical Co., Inc., 269 F.2d 734, 737 (3d Cir. 1959), wherein the Court quoted In re Fulton's Estate, 65 Pa. Super. 437, 442 (1917) as follows:

> ...[T]he appellant was also the pledgee of certain shares of bank stock which, through a trustee, he held as collateral security for the payment of his debt. Under the terms of the pledge he could not be compelled to surrender his security until his debt was paid in full. The insolvency or death of his debtor would in no way affect his right to the full use of his collateral. That right rested not on general laws disposing of the property of insolvent debtors, dead or alive, but on the contract of the parties. The fact that he thus had recourse to two funds in no way impaired his right to proceed against either or both so long as he did not claim or secure more than was justly due. As we said in Peckham's Est., supra: "He was entitled to pursue all of his remedies and use all of his securities without having the efficiency of any one diminished by the fruits derived from any other, so long as the result of all was to give him less than his debt": Miller's App., 35 Pa. 481; Graeff's App., 79 Pa. 146. (Emphasis supplied.)

The Trustee contends that Baroff's general estate has a superior right to the insurance proceeds in that the general estate has also suffered a loss in connection with the Corey claim. There is no dispute that American's loss, for which Baroff is liable, is predicated on the criminal conduct of Baroff's employee who knowingly aided and abetted in the sale of Corey's stolen securities. (p. 16a.) The purported loss suffered by the general estate is based on

American's utilization of the collateral* which the Trustee contends resulted in a reduction of funds available to the general creditors.** However, the general creditors had no interest in the collateral until American's claim was fully satisfied.

Further, American's rights under Section 167 were not abrogated merely because of Baroff's purported loss for the statute specifically protects the injured claimant by enabling him to recover the proceeds independent of any bankruptcy proceeding, where, as here, his claim has not

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* The net proceeds of sale of the collateral were $79,312.62. The Trustee also argues that the $14,369.41 paid by Baroff to Corey and Loeb Rhodes & Co. constituted a loss. (Trustee's Brief, p. 7). That payment was made in 1971 prior to the institution of the liquidation proceedings. The Trustee, however, did not recover this amount from INA until after American instituted the present proceedings to recover all the insurance proceeds. Accordingly, the argument set forth above as to American's right to the insurance proceeds, irrespective of when it utilized the collateral, is applicable to the $14,369.41 as well.

** By virtue of the Trustee's assignment of the insurance proceeds to SIPC for its administrative claim (supra at p. 8), the proceeds, which the Trustee contends were a substitute for American's collateral, have not been made available to general creditors. Accordingly, no actual loss would be sustained by the general creditors if American received the proceeds.

been satisfied. But for the liquidation proceeding, had Baroff collected the insurance proceeds, American could have levied execution thereon to satisfy any portion of its claim which remained unsatisfied after the application of its collateral. Similarly, if the proceeds had not been paid, American could have proceeded directly against INA under Section 167. Thus, the fact that Baroff may have sustained a "loss" would not shield the proceeds from American.

The purpose of Section 167 is to provide an injured claimant with the proceeds of an insurance policy maintained by an insolvent debtor and not to shield those proceeds from the innocent injured party (Appellant's Brief pp. 13-14). Yet, the Trustee's position, if sustained, would have such a result.

CONCLUSION

For the reasons hereinabove set forth, it is respectfully submitted that the orders of the District Court and the Bankruptcy Court should be reversed and that American should be awarded summary judgment.

Respectfully submitted,

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STATE OF NEW YORK
CITY OF NEW YORK } ss.:
COUNTY OF NEW YORK

John J. Farrell, being duly sworn, deposes and says, that he is over 18 years of age. That on the 13th day of August, 1976, he served three (3) copies of the attached Reply Brief on the attorney for the Securities Investors Protection Corp herein by depositing the same, properly enclosed in a securely sealed post-paid wrapper, in a U. S. Post Office at 90 Church Street, New York City, directed to said ~~attorney~~ at parties as follows:

Securities Investors Protection Corp
Suite 800
Barrister Building
900 - 17th Street N.W.
Washington D.C. 20006

that being the place where they maintain ~~their an~~ offices for the regular transaction of business, and the last address mentioned in the papers last served by them

John J. Farrell

Sworn to before me this
13th day of August, 1976.

Monroe D. Rosen

MONROE D. ROSEN
Notary Public, State of New York
No. 24-4616690
Qualified in Kings County
Commission Expires March 30, 1977

Service of three (2) copies of the within
is admitted this 13TH day of August 1976

Martin S Cohn
Chief Attorney, Rm # 2

Hughes Hubbard & Reed

Securities Exchange Commission

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